Chilton Investment Services
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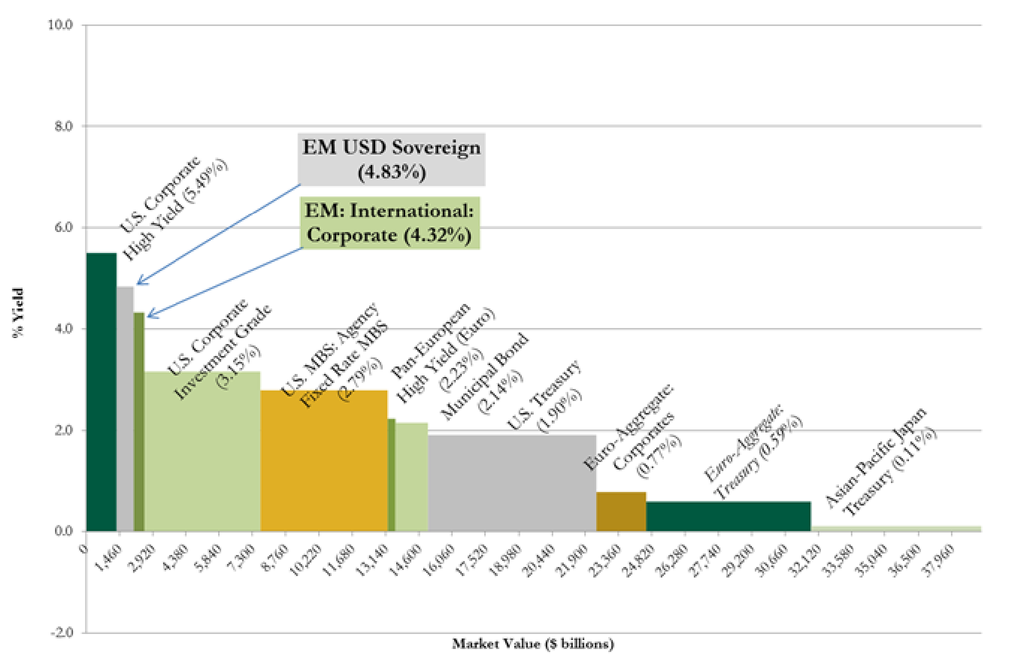
Emerging Markets: Asia Is The Place To Start

In an environment of low interest rates and a gradual normalization of central bank monetary policy accommodation, we recommend increasing credit spread in client portfolios. Despite a strong rally year-to-date, sovereign and corporate bonds issued by emerging market issuers continue to offer incremental yield for US-based investors (see Chart 1). This additional yield, fundamental growth trends and increasing acceptance by investors has led to solid total returns with emerging market US dollar-denominated debt returning an average 5.7% over the past 5 years[i], beating investment-grade US corporates (4.1%)[ii] and municipal bonds (3.3%)[iii]. And unlike US high yield, the sector offers diversification benefits for US-focused investors. One constraint to note - the sector is much smaller in size than the US corporate or Treasury markets.

Chart 1: Global Fixed Income Asset Classes (Index % Yield)



Source: Bloomberg Barclays Benchmark Indicies, Bloomberg LP & Barclays PLC

Investment Recommendations

Our recommendation is for a strategic portfolio allocation of 15-25% invested in emerging market credit with the best thematic idea being an overweight to emerging Asia. The region has relatively faster rates of economic growth (Table 1), cultures with strong entrepreneurial and educational underpinnings, and broadly pro-growth economic policies. This piece will outline our fundamental views of the major Asian emerging markets and offer some basic issuer and sector recommendations.

Table 1: Asian Emerging Markets Boast Strongest Growth Rates

GDP Growth (%)		
	Current	2018 Forecast
CHINA	6.9	6.4
PHILIPPINES	6.5	6.5
INDIA	6.1	7.3
MALAYSIA	5.8	4.8
VIETNAM	5.7	6.5
INDONESIA	5.0	5.4
TURKEY	5.0	3.2
POLAND	3.9	3.4
THAILAND	3.7	3.5
ISRAEL	3.0	3.3
RUSSIA	2.5	1.5
MEXICO	1.8	2.2
COLUMBIA	1.3	2.8
SOUTH AFRICA	1.0	1.2
CHILE	0.9	2.5
BRAZIL	-0.4	2.1
Emerging Market Median	**3.9**	**3.3**
Developed Market Median	**2.5**	**2.0**

Source: International Monetary Fund

Our investment process begins with a top-down assessment of fundamental economic and policy conditions within a country. We then consider overall yield levels. Shown in Table 2 is a weighted average of each country's investment-grade and BB-rated bonds in the Bloomberg Barclays Asia Emerging Market Index. As shown, bonds issued by the governments, corporations and banks of India, China and Vietnam currently offer the greatest amount of additional credit spread per year of duration.

Table 2: Indian Issuers offer Widest Credit Spreads

	Credit Spread / Duration (basis points)
INDIA	32.2
VIETNAM	31.4
CHINA	29.3
THAILAND	24.8
INDONESIA	17.5
MALAYSIA	15.9
PHILIPPINES	9.4

Source: Bloomberg Barclays Emerging Markets Asia USD Index

While the majority of any Asian allocation is likely to be comprised of credits from China which represents 50% of the emerging Asia bond market[iv], other economies offer similar investment risk-reward characteristics with diversification benefits. We quantify the degree to which the other Asian economies are linked to China by multiplying the percent of a nation's GDP derived from exports by the percent of those exports destined for China (Table 3).

Table 3: Understanding China Exposure Informs Diversification Goal

	A	B	A x B
	Exports as % GDP	Exports to China as % Exports	China Exposure
Vietnam	86.1%	15.8%	13.6%
Malaysia	66.1%	13.8%	9.1%
Thailand	51.7%	12.0%	6.2%
Philippines	18.5%	10.8%	2.0%
Indonesia	15.0%	12.7%	1.9%
India	11.5%	3.8%	0.4%
China	18.6%	-	-

Source: International Monetary Fund, Chilton Investment Services LLC

We recommend an index-Neutral position to China, Malaysia, the Philippines and Vietnam; Overweight India and Indonesia; Underweight Thailand. Our sector and issuer-specific recommendations are supported by the relative value charts in the appendix at the end of this publication.

- China (neutral) – strong growth; expanding technology sector; very high leverage; short-maturity government and state-owned bank bonds, as well as those issued by China National Offshore Oil Corporation (CNOOC), appear attractive; Baidu is less attractive than Alibaba and Tencent on a leverage-adjusted basis

- Malaysia (neutral) – diverse, open economy; good trade competitiveness; high consumer debt; Petronas bonds looks attractive on a leverage-adjusted basis; government bonds are tight

- The Philippines (neutral) – strong, pro-growth government; low debt and deficit levels; valuations improved and reflect stronger profile than public credit ratings

- Vietnam (neutral) – strong export / manufacturing sector; gradual loosening of state controlled economy; rapid credit expansion; high budget deficit; government bonds appear fairly priced

- India (overweight) - large economy with limited external vulnerability; proceeding with fiscal reforms; future reform necessary in banking sector; spreads are wider on many banks, reflecting asset-quality concerns which we continue to monitor; Bharti Airtel spreads appear attractive

- Indonesia (overweight) – reform-minded administration; policy goal to diversify commodity-linked economy; low leverage; Pertamina Persero looks attractive; Perusahaan Listrik does not

- Thailand (underweight) – political uncertainty; declining trade competitiveness; high consumer debt; inadequate spread compensation on Bangkok Bank

Fundamental Analysis

The story begins with China, the 3rd largest economy in the world. The country's multi-decade development story has progressed to a point at which it falls somewhere in the middle of the emerging nations - no longer enjoying an undisputed manufacturing cost advantage but yet to attain per capita GDP levels on par with developed nations. Living standards have improved dramatically since Deng Xiaoping commenced reforms in 1978 and the nation continues a well-publicized transition toward a consumer-led economy. In particular, the country is making strides toward developing a more globally-competitive technology sector while deemphasizing legacy manufacturing sectors. Debt levels remain the most salient concern. Private and public sector debt represents over 200% of GDP, the highest in our emerging market coverage (Table 4). This figure is up from 162% 5 years ago and 138% 10 years ago. The most unsettling element of this surge in credit has been the rise of non-traditional lending channels, generally referred to as the "shadow banking" sector. China's government has made financial sector reform a policy priority and the new head of the China Banking Regulatory Commission (CBRC), Guo Shunqing, has moved aggressively to introduce regulation aimed at reining in the excesses of the financial system. Interbank borrowing rates have marched higher as regulators focus on raising standards for funding transactions. Bolstered by an excellent foreign currency reserve position, the People's Bank of China remains in good shape to manage interest rate fluctuations over the medium term. A correction in the credit markets and / or broader recession could materialize if the country is not able to maintain its target economic growth rate (currently 6.5%) while simultaneously reducing leverage, a daunting policy challenge.

Table 4: China Most Indebted ; Indonesia Least

	Debt/GDP (%)
INDONESIA	67.6
RUSSIA	71.8
PHILIPPINES	77.3
MEXICO	92.2
COLUMBIA	92.9
TURKEY	100.2
POLAND	109.4
SOUTH AFRICA	119.3
INDIA	120.0
ISRAEL	129.1
CHILE	136.9
BRAZIL	143.4
VIETNAM	175.3
MALAYSIA	180.1
THAILAND	189.4
CHINA	206.0
Emerging Market Median	**114.5**
Developed Market Median	**167.3**

Source: Chilton Investment Services LLC

India offers an interesting case as it gradually progresses with long-anticipated reforms of its large, dynamic but consistently underperforming economy. The country has low China risk as just 0.4% of GDP is derived from export sales to its northern neighbor. Unlike many other emerging markets, as a commodity importer, India benefits from weak global commodity prices. Consequently, inflation is currently at historically low levels, with CPI rising just 2.2% in the 2Q17, significantly lower than the average 8.1%

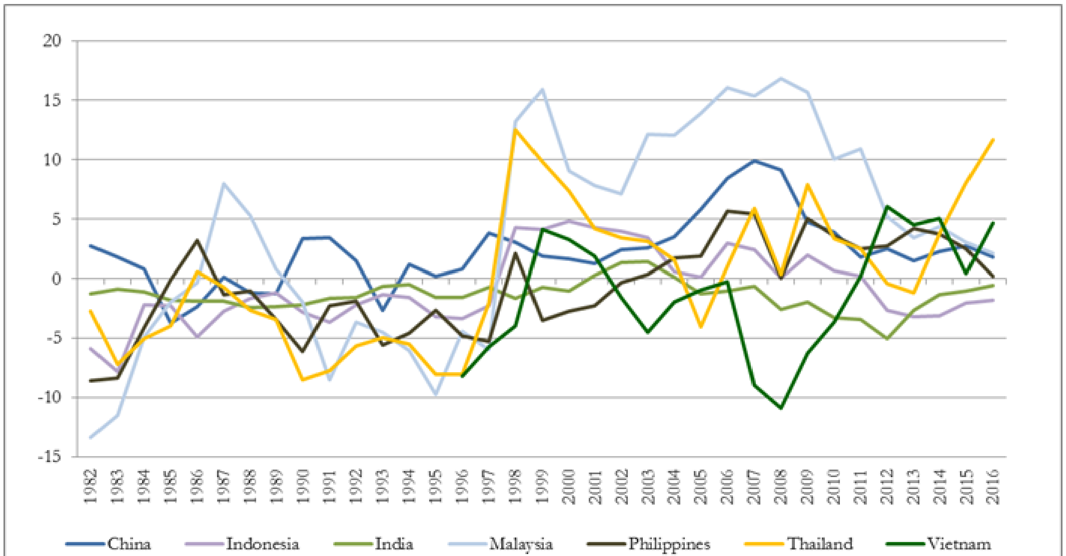
since 2010. The country has improved its current account deficit to -0.6% of GDP (vs. -5.1% 5 years ago) and external debt represents a low 19% of GDP. However, India's relative insulation from the global environment has led to a less dynamic corporate sector with higher leverage and weaker profitability. Public sector leverage is also above-average though recent reforms have been focused on this area. In an effort to reduce the black market economy, the government in November 2016 made a surprise announcement that over 85% of the cash currency in circulation would be voided within 50 days, an effort to reduce the size of the untaxed, cash economy. Perhaps more impactful is the introduction of the new Goods and Services Tax in July 2017, a measure which eliminated roughly 40 prior Federal or local taxes and levies and introduced a computer-based payment network to improve compliance. Future reforms must address the country's banking sector and further liberalization of the foreign trade sector.

Indonesia also is relatively insulated with 1.9% of GDP tied to China exports. A growing domestic middle class has supported solid growth rates of 5-6% since 2010. Inflation below 4% has afforded cover for an additional 50 basis points of interest rate cuts this year which is hoped to boost GDP growth rates closer to the official target of 7%. Commodities (primarily coal) represent the largest source of export revenue as well as a major source of foreign direct investment. As such, the economy remains highly cyclical and a persistent current account deficit over the last several years highlights the vulnerability of the Indonesian Rupiah to swings in global coal prices. Following the election of President Joko Widodo in 2014, a round of structural reforms targeted public sector fiscal efficiency as well as modest liberalization of the manufacturing sector in an attempt to diversify away from mining and position the country as a lower cost manufacturing alternative to China. The Financial System Crisis Prevention and Mitigation Law in 2016 provided additional institutional strength to the already sound banking sector. Leverage is the lowest of our Asian coverage with combined public and private sector debt / GDP just 68% of GDP (Table 4).

Like Indonesia and India, the Philippines has modest China exposure (2% of GDP) as domestic growth has been accelerating. GDP growth accelerated from 6.1% in 2015 to 6.9% last year with an official government target of 7-8%. Inflation is well contained at just 3.1% and only modest increases are anticipated over the near term. A 6-year, $180 billion government-led infrastructure spending program is aimed at reducing logistical bottlenecks that have traditionally impeded commerce in this nation of over 7,500 islands. Public finances are in decent shape to afford this fresh spending. The budget deficit, while recently increased, is still a relatively low 2.4% of GDP and combined debt to GDP is the 2nd lowest in our Asian coverage. Likewise, the country is starting from a position of strength externally. With a current account surplus for the past 15 years (remittances from Philippine citizens working overseas have historically represented a sizable positive inflow), the country has made a policy decision to allow the account to slip into deficit as infrastructure spending drives a surge in capital goods imports. The central bank's ability to manage the impact of this fiscal expansion in terms of inflation and the value of the Philippine peso will be the key catalyst moving forward.

Thailand demonstrates a relatively weaker domestic growth profile and remains heavily tilted toward global markets as exports represent over 2/3 of GDP. China exposure is moderate with the value of exports to that country representing 6.2% of GDP. With the pickup in global economic activity in 2016, the country's external position has significantly improved with a current account surplus equal to 11.7% of GDP, highest of our emerging Asia names (Chart 2). However domestic growth is more moderate than some Asian peers with high consumer debt levels depressing consumption. Furthermore, there are concerns that the country is losing ground to other, lower-cost neighbors such as Cambodia in the competition for foreign direct investment (FDI). Reforms designed to increase the information technology sector have languished. The banking sector remains adequately capitalized though low interest rates and new curbs on consumer credit growth could curb profitability. Public finances are in good shape though the country remains susceptible to ongoing political risk given the country's oft unsettled relations between the military and elite ruling families, primarily the Shinawatra's. The military has governed since a 2014 coup deposed former President Yingluck Shinawatra.

Chart 2: Current Account Balances Have Improved

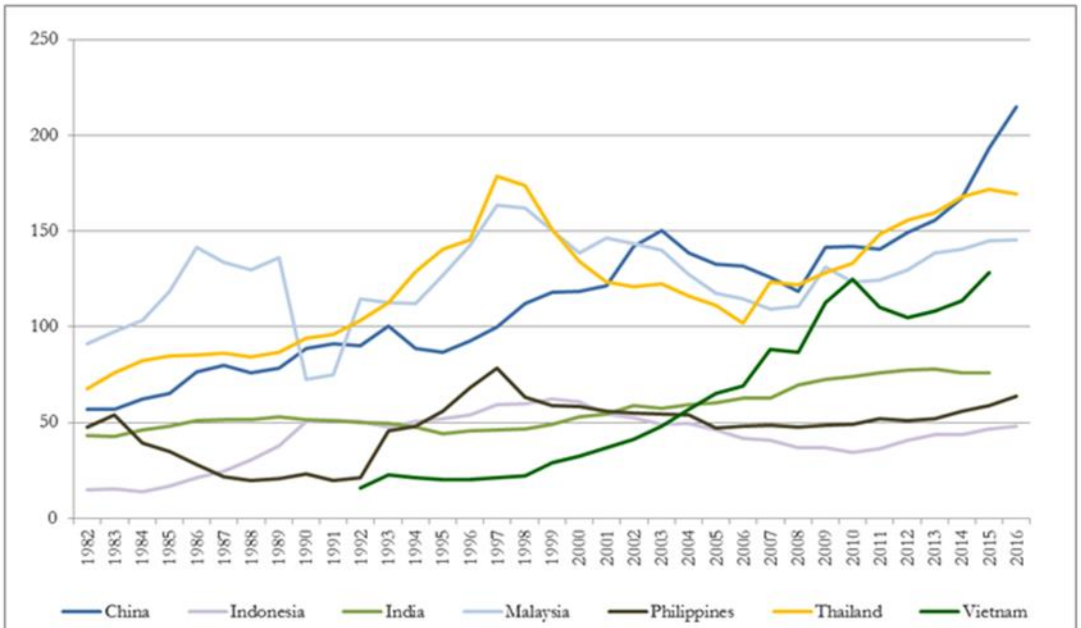


Source: World Bank

Malaysia represents one of our strongest emerging Asian names, although its open, export-oriented economy makes it vulnerable to global financial market cycles. It also has elevated China exposure at 9.1% of GDP. The economy is highly developed and very diversified with both technology and commodity exports representing key sectors. This diversification is evident in the country's relative resilience despite the commodity price collapse in 2014-15. GDP growth has rebounded to 5.8%, a good rate for a nation with a relatively high per capita income of $13,958. Inflation is running above 4% year-to-date but is viewed as temporary given recent, commendable government reductions in various fuel and food subsidies. Household debt is high but unemployment is low at 3.1%. External finances are reflective of an open economy with favorable terms of trade – the current account is consistently in surplus (2.1% as of 2016). However external debt is a high 68% of GDP. Current policy initiatives include education and productivity reforms, and reducing the government budget deficit towards a target of -3%, a very achievable goal.

Vietnam trails its neighbors in terms of development progress, having only begun economic liberalization with the so-called "Đổi mới" reforms initiated in 1986. The long term outlook is positive as the Communist government moves gradually toward a more open economy. To date this has included development of a strong manufacturing / export sector, leveraging the country's position as a relatively more affordable alternative to China. However, many reforms are proceeding slowly including privatization of state-owned companies following a loosening of foreign investment limits in 2015. There is a fairly high level of medium term risk due to rapid growth in debt levels. As shown on Chart 3, there has been a notable acceleration in private sector debt outstanding since the late 1990's and Vietnam has joined our group of most highly leveraged Asian countries. This trend shows no sign of abating as the Communist government recently raised its target for annual credit growth to 21% from 18% in order to boost GDP growth rates to the upper 6% range (6.2% in 2016). There is less room for fiscal stimulus given the high -5.5% budget deficit. Trade linkage with China is the highest in our sample at 13.6% of GDP. Inflation has been volatile, ranging from a recent high of 18% in 2011 to a low of 0.6% in 2015 as commodity prices collapsed. The country cannot be considered a free-market economy as many prices remain controlled with the State mandating rates for sectors such as health care, agriculture and education.

Chart 3: Credit Growth in Certain Economies is Concerning



Source: World Bank

<u>Appendix: Relative Value Charts</u>

Chart 4: Asia Government Bonds

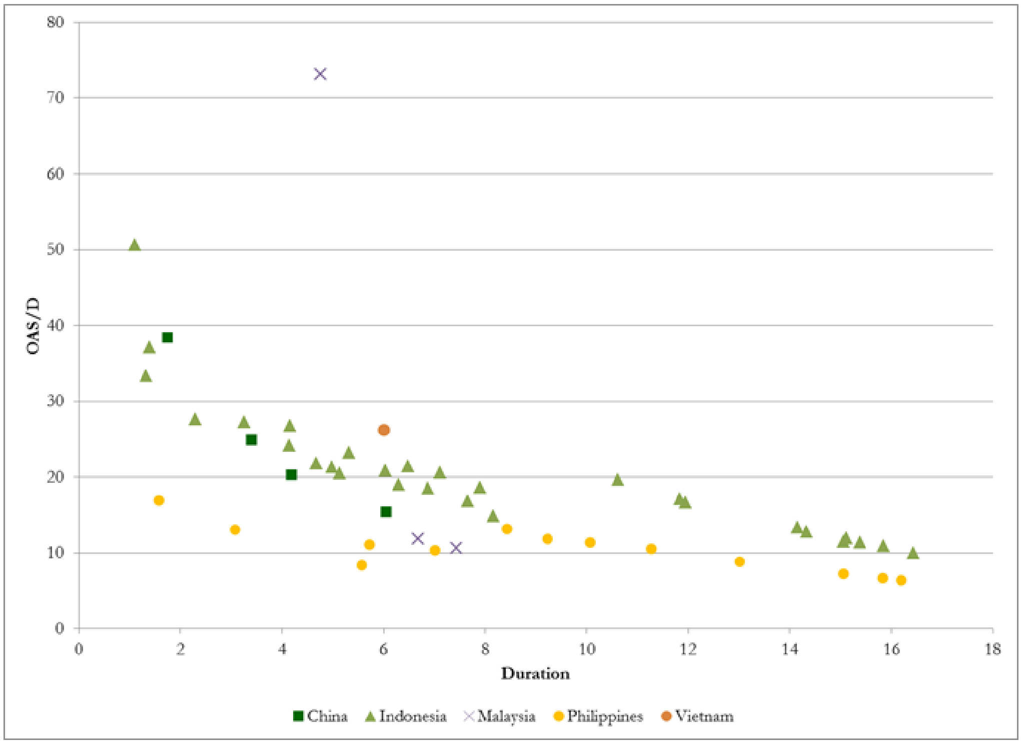


Chart 5: Asia Corporate Bonds

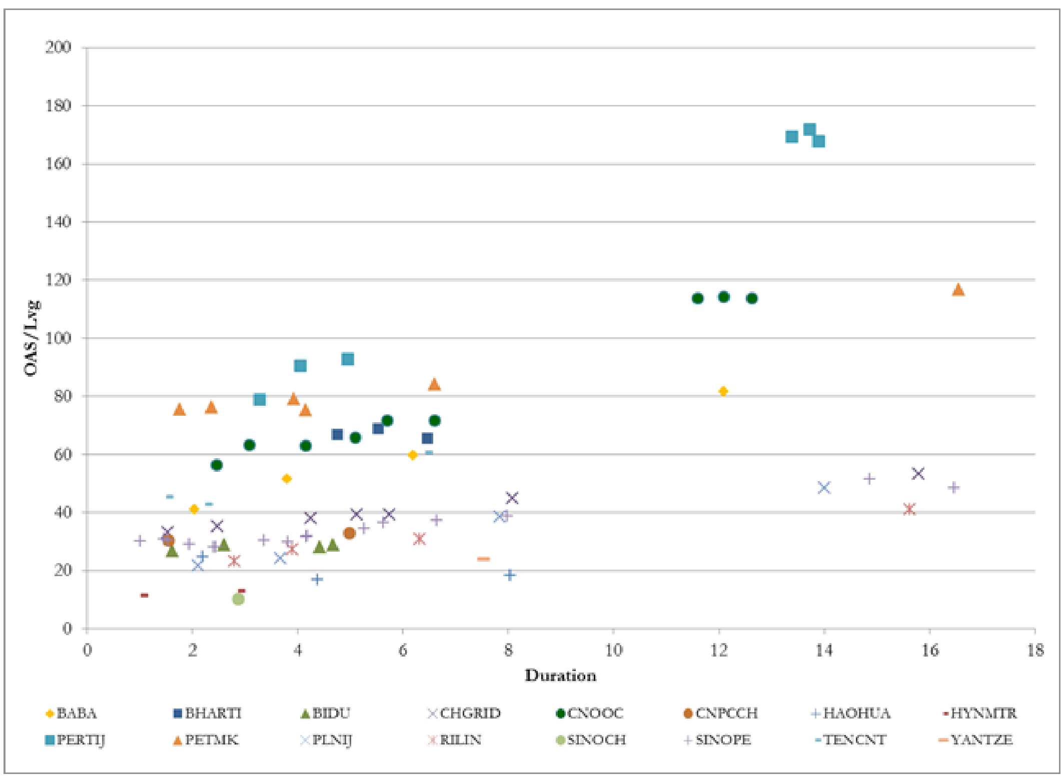
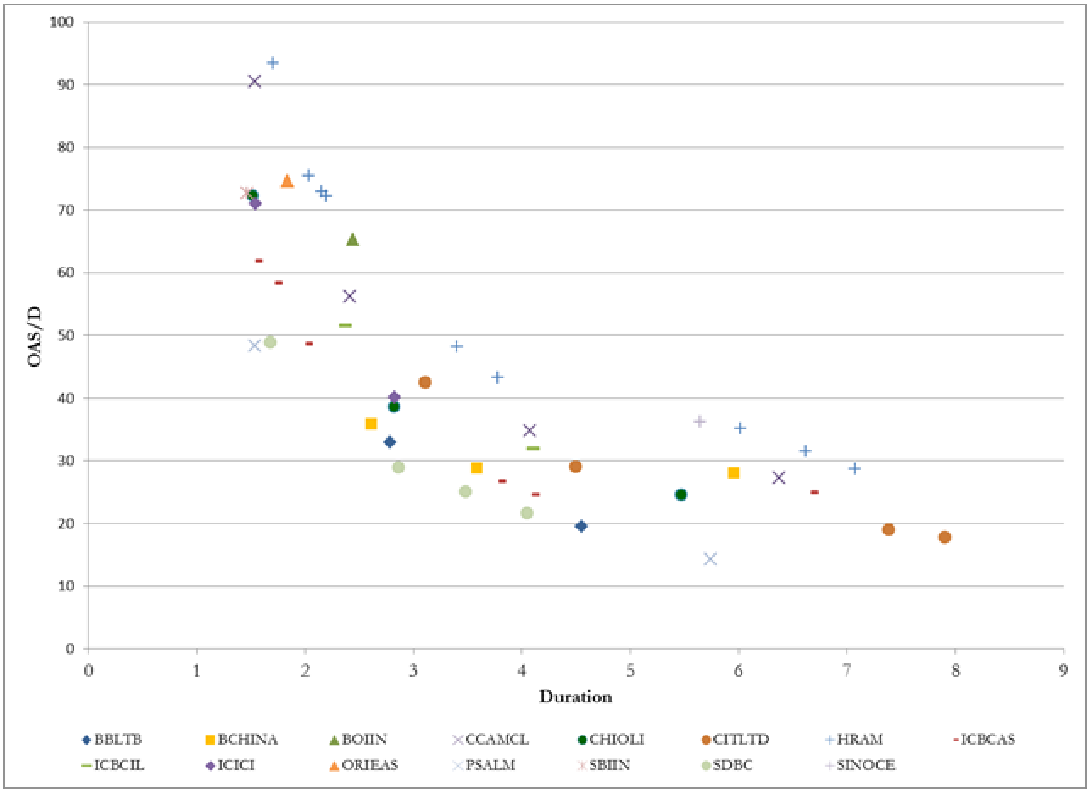


Chart 6: Asia Financial Bonds



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[i] Bloomberg Barclays EM USD Aggregate Total Return Index
[ii] Bloomberg Barclays US Corporate Total Return USD Index
[iii] Bloomberg Barclays Municipal Bond Index Total Return Index
[iv] Market defined as Bloomberg Barclays Emerging Markets Asia Total Return Index USD